



STATE OF WASHINGTON

ECONOMIC AND REVENUE FORECAST COUNCIL

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May 26, 2006

TO: Governor's Council of Economic Advisors

FROM: ChangMook Sohn, Executive Director
Economic and Revenue Forecast Council

SUBJECT: PRELIMINARY JUNE ECONOMIC FORECAST

This preliminary forecast was based on Global Insight's May Control forecast for the U.S. economy. You should have received a summary of the Global Insight forecast by email. If not, please contact our office. The forecast incorporated the advance GDP estimate for the first quarter of 2006. According to the advance estimate, real GDP grew at a 4.8 percent rate in the first quarter of 2006, up sharply from 1.7 percent in the fourth quarter of 2005. The rebound in final sales was even sharper, from a negative 0.2 percent to a positive 5.4 percent. The strong first quarter was expected as the economy bounced back from the weak fourth quarter. Payroll employment growth improved to 1.7 percent in the first quarter from 1.2 percent in the fourth quarter. This apparent improvement mainly reflects the adverse impact of Katrina on fourth quarter employment. Excluding Louisiana, national employment growth slowed slightly to 1.6 percent in from 1.7 percent. The unemployment rate declined from 4.93 percent in the fourth quarter to 4.73 percent in the first quarter. On March 28th the Federal Open Market Committee raised its target for the federal funds rate by 25 basis points to 4.75 percent.

Overall, the national forecast is very similar to the forecast adopted in February. There is very little difference in the current biennium except higher inflation due to higher energy costs. GDP, employment, and nominal income are slightly higher in the next biennium but inflation is lower as oil prices start out higher but fall faster than assumed in February. Oil prices (West Texas Intermediate) are expected to decline from a peak of \$71 in the third quarter of 2006 to \$56 by the end of 2009. As expected in the forecast, the Fed raised its target interest rate 25 basis points to 5.00 percent on May 10. The Fed is expected to increase its target rate again in June bringing the federal funds rate to 5.25 percent before easing slightly in 2007.

A comparison of the preliminary U.S. forecast with the forecast adopted in February is shown in Table 2.

The Washington aerospace employment forecast incorporates a downward revision of 1,800 to the April 2006 level due to a revision in the historical data and weaker than expected growth.

The forecast expects another 8,900 new aerospace jobs by mid-2008 when it is expected to level off at 80,700. This is still 32,400 (28.7 percent) lower than the previous peak in June 1998. The software wage forecast is essentially unchanged since February. Software employment is expected to grow about 7,300 from now through the end of 2009 which translates into a growth rate of 2,000 jobs per year. Higher interest rates will have an adverse impact on the Washington housing market but this will be offset by strong population growth. In addition, nonresidential construction is expected to recover. Overall Washington construction employment is expected to continue to expand but at a much reduced rate.

This forecast also incorporates newly available Quarterly Census of Employment and Wages (QCEW) data for the fourth quarter of 2005. The benchmark revision to the fourth quarter added 2,100 to the level of employment in the month of December. In addition, employment growth from December through April was 14,400 stronger than expected leaving April's employment 16,500 higher than expected in the February forecast.

We have more up-to-date QCEW data for wages in the fourth quarter of 2004 and all four quarters of 2005 than did the Bureau of Economic Analysis (BEA) at the time of their latest state personal income release. As a result, our estimates of wages in those quarters differ from the published BEA estimates. The QCEW data indicate that fourth quarter wages were \$1.026 billion lower than expected in February. Software wages were \$0.230 billion higher than expected. Non-software wages, however, were \$1.256 billion lower. Nonwage personal income was \$0.010 billion below the February estimate. The revision to total personal income in the fourth quarter was net reduction of \$1.037 billion.

The forecast also reflects Seattle consumer price data through December. After trailing the national average during 2002, 2003, and 2004, December-December Seattle core inflation (excluding food and energy) edged ahead of the national average, rising 2.3 percent compared to 2.2 percent. During the first four months of 2006 core inflation in Seattle shot up at an annual rate of 6.0 percent, twice the 3.0 percent U.S. rate. Because energy rose less locally than elsewhere in the U.S., the gap in overall inflation was smaller. The overall Seattle CPI rose at an annual rate of 6.2 percent in the first four months of the year compared to 5.1 percent for the U.S. city average.

The number of housing units authorized by building permit fell 10,200 in the first quarter of 2006 to 47,500 from 57,700 in the fourth quarter. This was the weakest showing for housing permits in Washington in two years. Single-family permits fell 7,800 to 35,800 and multi-family permits fell 2,300 to 11,700.

A comparison of the preliminary Washington forecast with the forecast adopted in February is shown in Table 3.

Preliminary February Economic Forecast
May 26, 2006
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Review of the forecast by the Governor's Council of Economic Advisors is scheduled for Friday, June 2, 2006 at 10:00 a.m., in the Governor's Conference Room.

If you have any questions, please contact Bret Bertolin, Senior Economic Forecaster, at (360) 570-6106.

PLEASE NOTE:

Enclosed is a worksheet summarizing the preliminary forecast. **Council members are strongly encouraged to complete and return this worksheet either in person at the Governor's Council meeting or, if unable to attend, by FAX to (360) 753-7022.** This worksheet is relied on by the Forecast Council members and staff to gauge the reasonableness of the preliminary economic forecast and also serves as the basis of an alternative economic and revenue forecast.

Fluctuations in software wages cause significant distortions in overall wage and personal income trends. In particular, Microsoft's stock awards vest in the third quarter of each year. Microsoft also pays bonuses in the third quarter. Since the Bureau of Economic Analysis does not seasonally adjust software wages, this causes an apparent jump in wages in the third quarter of each year and drop in the fourth quarter. Other quarters are less affected. Also, Microsoft stock option income can vary widely from quarter to quarter and from year to year. The following table shows what growth would have been without these factors.

	2006Q2	2006	2007	2008	2009:1,2
<u>Real Personal Income, %Ch.</u>					
Baseline	2.6	4.3	5.4	4.9	4.3
Excluding Software	3.3	4.3	5.4	4.8	4.8
Difference	-0.7	0.0	0.0	0.1	-0.5
<u>Average Annual Wage, %Ch.</u>					
Baseline	3.0	3.7	4.1	4.3	3.4
Excluding Software	4.5	3.7	4.1	4.2	4.4
Difference	-1.4	0.0	0.1	0.1	-1.0

CMS: bb
Enclosures

Table 1
U.S. Economic Forecast Comparison
May 2006

	2006Q1	2006Q2	2006Q3	2006Q4	2006	2007	2008	2009
Real GDP, Percent Change								
Global Insight	4.8	3.2	2.6	2.8	3.3	2.7	3.2	3.3
Blue Chip	4.8	3.4	3.0	2.8	3.4	3.0		
Economy.com	4.8	3.6	3.4	3.1	3.5			
S&P	4.8	3.5	2.7	2.8	3.4	2.6	2.9	3.1
Merril Lynch	4.8	3.2	2.8	2.5	3.3	2.5		
Federal Funds Rate								
Global Insight	4.46	4.89	5.25	5.25	4.96	4.98	4.75	4.94
Blue Chip*	4.4	4.9	5.2	5.2	4.9	5.1		
Economy.com	4.46	4.89	5.00	5.00	4.84			
S&P	4.5	4.9	5.0	5.0	4.8	5.0	5.0	5.0
Consumer Price Index, Percent Change								
Global Insight	2.2	5.0	1.1	0.0	3.2	1.5	1.6	1.5
Blue Chip	2.2	3.2	2.4	2.4	3.1	2.5		
Economy.com	2.2	2.4	2.4	2.2	3.0			
S&P	2.2	5.1	1.1	0.0	3.2	1.5	1.6	1.4
Merril Lynch	2.2	3.8	1.2	0.1	2.9	0.8		
Payroll Employment, Millions								
Global Insight	134.7	135.3	135.8	136.3	135.5	137.5	139.4	141.1
Economy.com	134.8	135.3	135.8	136.3	135.5			
S&P	134.7	135.3	135.9	136.3	135.5	137.5	139.1	140.6
Unemployment Rate, Percent								
Global Insight	4.7	4.7	4.7	4.7	4.7	4.8	4.8	4.6
Blue Chip	4.7	4.7	4.7	4.7	4.7	4.8		
Economy.com	4.7	4.8	4.8	4.8	4.8			
S&P	4.7	4.7	4.7	4.7	4.7	4.8	4.9	4.9
Merril Lynch	4.7	4.7	4.8	4.9	4.8	5.2		
Real Disposable Personal Income, Percent Change								
Global Insight	3.2	2.1	3.9	4.4	3.0	3.8	3.9	3.7
Blue Chip	3.2	3.6	3.5	3.3	3.3	3.3		
Merril Lynch	3.2	3.3	3.2	3.0	3.2	2.5		

* Estimate based on T-bill rate.

Table 2

U.S. Forecast Comparison

	2005Q3	2005Q4	2006Q1	2006Q2	2006Q3	2006Q4	2005	2006	2007	2008	2009
Real GDP (Billions of Chained 2000 Dollars)											
June	11202.3	11248.3	11381.4	11472.6	11547.8	11627.3	11134.8	11507.3	11818.7	12194.2	12590.7
Percent Change	4.1	1.7	4.8	3.2	2.6	2.8	3.5	3.3	2.7	3.2	3.3
February	11202.3	11233.5	11367.1	11453.9	11542.0	11613.7	11131.1	11494.2	11807.9	12153.0	12540.3
Percent Change	4.1	1.1	4.8	3.1	3.1	2.5	3.5	3.3	2.7	2.9	3.2
Implicit Price Deflator (2000=1.000)											
June	1.118	1.126	1.132	1.143	1.146	1.148	1.113	1.142	1.160	1.180	1.199
Percent Change	3.7	2.9	2.0	3.8	1.4	0.6	2.8	2.6	1.6	1.7	1.6
February	1.118	1.126	1.130	1.134	1.139	1.145	1.113	1.137	1.159	1.183	1.206
Percent Change	3.7	2.6	1.5	1.4	1.8	2.0	2.8	2.2	1.9	2.1	1.9
Real Personal Income (Billions of Chained 2000 Dollars)											
June	9164.7	9307.5	9401.0	9458.2	9559.5	9675.9	9206.4	9523.6	9907.1	10284.9	10700.8
Percent Change	-1.1	6.4	4.1	2.5	4.4	5.0	2.6	3.4	4.0	3.8	4.0
February	9147.4	9293.8	9406.6	9520.5	9622.2	9695.3	9198.6	9561.2	9890.9	10227.1	10609.3
Percent Change	-1.9	6.6	4.9	4.9	4.3	3.1	2.5	3.9	3.4	3.4	3.7
Wage and Salary Employment											
June	133.75	134.16	134.73	135.26	135.82	136.27	133.46	135.52	137.47	139.39	141.09
Percent Change	1.6	1.2	1.7	1.6	1.7	1.3	1.5	1.5	1.4	1.4	1.2
February	133.75	134.16	134.70	135.26	135.78	136.27	133.46	135.50	137.38	138.96	140.44
Percent Change	1.6	1.2	1.6	1.7	1.5	1.5	1.5	1.5	1.4	1.1	1.1
Unemployment Rate											
June	5.00	4.93	4.73	4.68	4.67	4.71	5.06	4.70	4.83	4.81	4.65
February	5.00	4.93	4.77	4.77	4.75	4.77	5.06	4.76	4.87	4.95	4.88
Mortgage Rate											
June	5.75	6.22	6.24	6.54	6.84	6.71	5.86	6.58	6.75	6.78	7.10
February	5.75	6.22	6.22	6.41	6.45	6.45	5.86	6.38	6.53	6.86	7.15
3 Month T-Bill Rate											
June	3.35	3.82	4.43	4.77	5.04	5.04	3.14	4.82	4.78	4.58	4.78
February	3.35	3.82	4.36	4.57	4.58	4.58	3.14	4.53	4.58	4.65	4.86

Table 3

Washington Forecast Comparison

	2005Q3	2005Q4	2006Q1	2006Q2	2006Q3	2006Q4	2005	2006	2007	2008	2009
Real Personal Income (Billions of Chained 2000 Dollars)											
June	202.675	202.010	204.977	206.306	212.854	213.139	200.647	209.319	220.697	231.446	242.452
Percent Change	6.0	-1.3	6.0	2.6	13.3	0.5	0.1	4.3	5.4	4.9	4.8
February	202.574	203.039	205.391	207.939	214.493	213.698	200.553	210.380	220.109	229.426	239.401
Percent Change	6.9	0.9	4.7	5.1	13.2	-1.5	0.3	4.9	4.6	4.2	4.3
Personal Income											
June	226.668	227.520	232.008	235.710	244.011	244.693	223.346	239.106	256.096	273.156	290.630
Percent Change	10.0	1.5	8.1	6.5	14.8	1.1	2.9	7.1	7.1	6.7	6.4
February	226.555	228.557	232.090	235.795	244.315	244.628	223.217	239.207	255.043	271.319	288.635
Percent Change	10.8	3.6	6.3	6.5	15.3	0.5	3.1	7.2	6.6	6.4	6.4
Wage and Salary Employment											
June	2785.7	2810.2	2845.7	2864.3	2882.6	2898.5	2777.6	2872.8	2942.2	3004.5	3054.6
Percent Change	2.7	3.6	5.2	2.6	2.6	2.2	2.8	3.4	2.4	2.1	1.7
February	2784.2	2814.0	2830.3	2848.1	2865.1	2881.2	2779.1	2856.2	2918.6	2970.6	3016.4
Percent Change	2.2	4.3	2.3	2.5	2.4	2.3	2.9	2.8	2.2	1.8	1.5
Manufacturing Employment											
June	269.9	276.9	280.1	282.5	284.8	286.0	271.9	283.4	289.2	290.9	290.3
Percent Change	-2.9	10.8	4.7	3.5	3.2	1.8	3.1	4.2	2.1	0.6	-0.2
February	270.0	277.3	280.1	281.8	283.1	284.0	272.0	282.3	286.1	287.8	288.4
Percent Change	-2.5	11.3	4.0	2.5	1.8	1.3	3.2	3.8	1.4	0.6	0.2
Construction Employment											
June	178.2	183.5	191.9	195.1	195.1	194.8	177.4	194.2	196.8	198.5	199.2
Percent Change	6.8	12.5	19.6	6.7	0.1	-0.7	8.1	9.5	1.3	0.9	0.4
February	177.1	182.6	184.1	185.5	186.0	185.9	177.2	185.4	187.2	187.7	188.3
Percent Change	3.3	12.9	3.4	2.9	1.1	-0.1	7.9	4.6	1.0	0.3	0.3
Housing Permits											
June	53.968	57.675	47.516	48.303	49.195	50.445	52.988	48.865	50.351	49.205	46.669
Percent Change	44.6	30.4	-53.9	6.8	7.6	10.6	5.8	-7.8	3.0	-2.3	-5.2
February	54.056	58.082	53.173	51.585	51.202	50.815	52.784	51.694	49.880	47.395	45.737
Percent Change	63.3	33.3	-29.8	-11.4	-2.9	-3.0	5.4	-2.1	-3.5	-5.0	-3.5

Advisor's Name: _____

Forecast Worksheet
May 26, 2006

	2006:Q2	2006	2007	2008	2009:1,2
<u>U.S.</u>					
Real GDP, %Ch					
Baseline	3.2	3.3	2.7	3.2	3.2
Your Opinion	_____	_____	_____	_____	_____
Implicit Price Deflator, % Ch					
Baseline	3.8	2.6	1.6	1.7	1.5
Your Opinion	_____	_____	_____	_____	_____
Mortgage Rate, Percent					
Baseline	6.5	6.6	6.8	6.8	7.0
Your Opinion	_____	_____	_____	_____	_____
Oil Price (WTI)					
Baseline	69.7	67.7	65.5	61.8	55.7
Your Opinion	_____	_____	_____	_____	_____
Probability next recession begins on or before 2009Q2			_____		
<u>Washington State</u>					
Real Personal Income, % Ch*					
Baseline	2.6	4.3	5.4	4.9	4.3
Your Opinion	_____	_____	_____	_____	_____
Wage and Salary Employment, % Ch*					
Baseline	2.6	3.4	2.4	2.1	1.6
Your Opinion	_____	_____	_____	_____	_____
Manufacturing Employment, % Ch*					
Baseline	3.5	4.2	2.1	0.6	-0.2
Your Opinion	_____	_____	_____	_____	_____
Construction Employment, % Ch					
Baseline	6.7	9.5	1.3	0.9	0.4
Your Opinion	_____	_____	_____	_____	_____
Housing Permits (Thousands)					
Baseline	48.3	48.9	50.4	49.2	47.4
Your Opinion	_____	_____	_____	_____	_____
Washington Average Annual Wage, % Ch*					
Baseline	3.0	3.7	4.1	4.3	3.4
Your Opinion	_____	_____	_____	_____	_____

* Please see important table on page three of the memo.